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## NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

October 24, 2007

Bruce Fort, Esq.  
Counsel  
Multistate Tax Commission  
444 North Capitol Street, NW, Suite 425  
Washington D.C. 20001-1538  
[bfort@mtc.gov](mailto:bfort@mtc.gov)

Re: Comments on Multistate Tax Commission's Proposed Model Statute  
for Taxation of Captive Real Estate Investment Trusts

Dear Bruce:

The National Association of Real Estate Investment Trusts (NAREIT)® thanks you for the opportunity to submit comments on the Multistate Tax Commission's (MTC) draft Proposed Model Statute for Taxation of Captive Real Estate Investment Trusts, which is posted on [www.mtc.gov](http://www.mtc.gov) (Final Draft). Furthermore, NAREIT would like to thank you for the opportunity to have participated over the last year in the MTC's process of preparing this draft.

NAREIT is the representative voice for U.S. real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

## EXECUTIVE SUMMARY

The Final Draft first provides that it is meant to address captive REITs only and should not be interpreted as precluding the right of a state to tax the income earned by any type of REIT as source income. The Final Draft then provides that a dividends paid deduction (DPD) should be added back for state corporate income tax purposes by a REIT that is a captive REIT.

A "captive REIT" is defined as a REIT, that is not: a) a publicly traded REIT and of which b) more than 50% of the voting power or value of beneficial interests or shares are directly or indirectly owned or controlled by a single taxable entity that is treated as an association taxable as a corporation under the Internal Revenue



Code of 1986, as amended (the Code). The Final Draft then excludes from the definition of entities treated as associations taxable as corporations: REITs, qualified REIT subsidiaries (QRSs); “listed Australian property trusts,” as specifically defined (LAPTs) (Australia’s version of the U.S. REIT) and/or trusts 75% or more held by an LAPT; and certain non-listed and listed foreign REIT-like entities.

NAREIT supports the Final Draft because it specifically addresses the DPD of “captive REITs” without affecting the DPD of widely held and/or publicly traded REITs. With that said, NAREIT continues to believe that the most appropriate model for state taxation of REITs and their shareholders is conformity with federal principles (as is the case for publicly traded REITs in all states but one that have an income-based tax system). Under this model, a state permits a (non-captive) REIT a DPD while taxing its residents on REIT dividends regardless of where the income giving rise to those dividends was generated.

Set forth below is background concerning the REIT structure and more details concerning our comments.

## **DISCUSSION**

### **I. Background**

#### **A. REITs Are Not “Tax Shelters,” But Were Designed to Benefit the “Small Investor.”**

Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through professionally managed companies. REITs combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, hotels, shopping centers, offices, timberlands, and warehouses. REITs are required to distribute at least 90% of their taxable income to their shareholders. In exchange for doing so (and for satisfying a number of other requirements), federal law grants REITs (and mutual funds) a DPD. In 2006, publicly traded REITs distributed more than \$15 billion to their shareholders.



## **B. REITs Benefit Investors and the Economy.**

Congress' vision has been realized: as of September 2007, more than 150 publicly traded REITs had a total equity market capitalization of more than \$370 billion. Throughout the U.S., real estate owned by REITs generates millions of dollars in property taxes on top of the individual income taxes currently generated by REIT dividends paid to state residents. Investors have benefited from owning REITs: the 15-year compound annual return for the period ending Aug. 31, 2007 of the S&P 500 stock index was 10.92%, **while that of REITs was 13.42%.**

The economy benefits from REITs as well – because REITs cannot pass through losses to investors (unlike partnerships), their focus must be on creating value for shareholders. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public REITs are less than 50%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Simply put, REITs are the most practical method for investors to add commercial real estate in their investment portfolios to obtain the asset diversification recommended by most financial advisors.

## **C. Most States Tax REIT Income Only Once at the Shareholder Level.**

All but one state with an income-based tax system allow the DPD for public REITs. As a result of the DPD, most, if not all, of a REIT's income is taxed at one level – the shareholder level. Only Mississippi limits its DPD to “publicly traded” REITs, a term which is not defined. In 2007, Maryland enacted legislation (identical bills, [H.B. 1257](#) and [S. 945](#)) that permits the DPD to reduce Maryland taxable income only for a REIT that is either: (i) publicly traded; or (ii) not more than 50% held by a taxable corporation that is not a REIT or an LAPT. Also in 2007, Kentucky ([H.B. 258](#)) and Indiana ([S. 500](#)) adopted statutes that are conceptually similar to the Maryland statute (although the triggering threshold in Kentucky is lower than in the other states). Louisiana adopted a similar statute in 2005, [H.B. 888](#). Other states adopting similar statutes this year include Illinois ([S.B. 1544](#)) and Rhode Island (H.B. 5300).

The above-mentioned statutes prevent or would prevent a REIT from being used primarily to escape state income taxes, while not disturbing the economic activities of widely held REITs.

## **D. Non-Publicly Traded REITs Are Used For Many Legitimate Transactions.**

Although there has been a great deal of press recently concerning the use of private REITs as a “state tax shelter,” the following legitimate structures are representative of REITs that are not publicly traded:

- SEC-registered, non-exchange traded REITs. There are a number of REITs that are required to register with the SEC due to the size of their shareholder and asset base, but are not traded on any exchange. Recently, several of these have become publicly traded.



- “Incubator” REITs that plan an eventual public offering. Several publicly-traded REITs began as privately-held REITs in order to establish a track record for management. Thereafter, they engaged in a public stock offering. Limiting the DPD to publicly traded REITs would negatively affect the business plans of these companies.
- Widely held, non-publicly traded REITs. There are also a number of REITs with sizeable property portfolios and shareholder bases that are privately held, often by tax-exempt institutions.
- Non-public subsidiaries of publicly traded REITs and LPTs. In certain cases, a publicly traded REIT that acquires another publicly traded or widely held REIT will keep the acquired company as a private REIT subsidiary for goodwill purposes or to avoid the need to obtain lender consents. Similarly, LPTs, Australia’s version of the U.S. REIT, often own U.S. REIT shares directly to facilitate compliance with the U.S.-Australian Tax Treaty by their small unitholders. Additionally, tax-exempt institutions and/or LPTs may invest, along with one or more publicly traded REITs, in a joint venture entity formed as a privately held REIT.

## II. Comments

NAREIT appreciates the careful thought undertaken by the MTC in preparing the Final Draft and appreciates the opportunity over the past year to provide comments to the MTC in connection with its preparation of the Final Draft.

We believe that the most appropriate method of taxation for REITs and their shareholders in states with income tax regimes is to conform to the federal model of taxation. As noted above, virtually every state with an income-based tax structure allows publicly traded REITs the DPD. Additionally, these states then tax all REIT dividend income received by resident shareholders, regardless of where the REIT’s real estate is located.

For example, State A imposes an income tax on all of the REIT dividends earned by a State A resident shareholder of a REIT with only State B properties, while State B imposes its income tax on all of the REIT dividends earned by a State B resident of a REIT with only State A properties. In that example, neither state imposes income taxes on the REIT based on the location of in-state property. If State A were to seek to impose an additional REIT-level tax on a REIT with State A properties, that would result in double taxation of that REIT’s income and inappropriate revenues to State A, making State A’s tax policy out of sync with the rest of the nation.

With that said, we recognize a state’s interest in adopting legislation that would limit any inappropriate use of REITs, including “captive REIT” structures that have been publicized recently, by denying the DPD in certain cases involving certain non public REITs. However, any



such legislation should be narrowly tailored to prevent application to legitimate uses of business transactions such as those described in the prior section. We support the Final Draft. To the extent that the MTC may wish to explore other types of limitations on the uses of captive REITs, including in those states that follow the "separate entity" method of reporting, again, we would welcome the opportunity to work with you further.

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Thank you again for the opportunity to submit these comments. Please contact me at (202) 739-9446, or my colleague Tony Edwards, at (202) 739-9408 if you would like to discuss these comments in more detail. I plan to attend the Nov. 6, 2007 MTC Uniformity Committee meeting via teleconference. I also plan to attend in person the Nov. 8, 2007 MTC Executive Committee meeting. I will be available to discuss these comments in more detail there as well.

Sincerely,

A handwritten signature in cursive script that reads "Dara F. Bernstein".

Dara F. Bernstein  
REIT Counsel

